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Kentucky Law Survey: Corporations

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Corporations

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Introduction

Due to continuing developments in federal corporation law as a result of activity by the Supreme Court of the United States, Part I of this article will follow the pattern of previous Surveys[1] by first reviewing two significant Supreme Court decisions. This will be followed by reference to a recent decision from the Sixth Circuit Court of Appeals. Part II will be devoted to a review of three selected cases concerned with state corporation law, including a case from the Sixth Circuit Court of Appeals applying Kentucky law pertaining to disregard of the corporate entity.

I. Federal Corporation Law

A. *Corporate Mismanagement*

Perhaps no topic has been more in the forefront of corporation law in recent years than that pertaining to the relative roles of federal and state law in dealing with the fiduciary responsibilities of corporate management.[2] Historically, the regulation of corporate managerial responsibility was considered to be a function of state regulation through the chartering

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[1] For previous corporation law surveys, see Ham, *Kentucky Law Survey—Corporations*, 65 Ky. L.J. 256 (1976); Ham, *Kentucky Law Survey—Corporations*, 64 Ky. L.J. 253 (1975); Ham, *Kentucky Law Survey—Corporations*, 63 Ky. L.J. 739 (1975).

[2] This was the topic of a symposium sponsored and organized by the Federal Regulation of Securities Committee of the Section of Corporation, Banking and Business Law of the American Bar Association, held at the Airlie House, Warrenton, Va., on June 13-14, 1975. *See Proceedings, The Airlie House Symposium, An In-Depth Analysis of the Federal and State Roles in Regulating Corporate Management*, 31 Bus. Law. 861-1213 (Special Issue, February 1976).

The term "corporate management" is used here to cover not only the fiduciary obligations of directors and officers but also those of controlling shareholders.

process.[3] However, after the adoption by the Securities and Exchange Commission (SEC) in 1942 of rule 10b-5,[4] which broadly condemns fraudulent and deceptive practices in connection with the purchase or sale of securities,[5] the federal courts found in it a new source for policing the fiduciary responsibilities of corporate management.[6] As a result, it was not long before much of the real action in this area of corporation law became federal.[7]

No doubt the high-water mark in the scope and application of rule 10b-5 on the part of the Supreme Court of the United States was reached in *Superintendent of Insurance v. Bankers Life & Casualty Co.*,[8] decided by the Court in 1971. In that case, the complaint charged a conspiracy between two individuals to purchase from Bankers Life & Casualty Co. all the stock of Manhattan Casualty Co. for their own benefit with Manhattan's assets.[9] It was alleged that the two individuals had secured a personal bank loan to make the purchase of the

[3] *See* Folk, *State Statutes: Their Role in Prescribing Norms of Responsible Management Conduct*, 31 BUS. LAW. 1031 (Special Issue, Feb. 1976). As Professor Folk remarks, "Indeed, the notion of a federal polity, as well as the whole history of corporation law in America, argues for 'primary jurisdiction' by the states, rather than federal preemption or even supplementation by federal law." *Id.* at 1032.

[4] 17 C.F.R. § 240.10b-5 (1977).

[5] The full text of the rule reads as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
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> in connection with the purchase or sale of any security.

Id.

[6] *See* Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW. 883 (Special Issue, February 1976).

[7] *See* Folk, *supra* note 3, at 1032.

[8] 404 U.S. 6 (1971). Actually, this was only the second case involving § 10(b) and rule 10b-5 to be reviewed by the Supreme Court, despite the extensive volume of litigation involving § 10(b) and rule 10b-5 that had developed by this time in the lower federal courts. The first case was SEC v. Nat'l Sec., Inc., 393 U.S. 453 (1969), in which the Court held, *inter alia*, that the exchange of stock in a merger constitutes a "purchase" of stock for purposes of § 10(b) and rule 10b-5.

[9] 404 U.S. at 7.

stock and, after securing control of Manhattan, had repaid the loan with money obtained from the sale of a quantity of United States Treasury bonds held by Manhattan as an investment.[10] The Court held that this alleged "bootstrapping" operation, if proved, stated a cause of action under section 10(b) of the Securities Exchange Act of 1934,[11] the source of rule 10b-5.[12] Speaking of section 10(b), which authorizes the SEC to adopt rules and regulations prohibiting the use of "manipulative or deceptive" devices or contrivances in connection with the purchase or sale of securities,[13] Mr. Justice Douglas remarked, on behalf of the Court, that "[s]ection 10(b) must be read flexibly, not technically and restrictively."[14] He went on to hold that there was a sufficient connection between fraudulent conduct and a sale of securities if the plaintiff's injury was "a result of deceptive practices touching its sale of securities as an investor."[15] This liberal conception as to the type of fraudulent conduct that could be brought within the ambit of section 10(b) and rule 10b-5 led to considerable speculation whether the reach of rule 10b-5 could be extended to regulate the fairness of corporate transactions as well as to assure their proper disclosure.[16]

Any such possible extension of rule 10b-5 now seems foreclosed. In more recent decisions the Supreme Court has made it clear that it expects a more narrow and restrictive reading of section 10(b) and rule 10b-5. Its opinion in *Santa Fe Indus-*

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[10] *Id.* at 7-8.

[11] 15 U.S.C. § 78j(b) (1970).

[12] 404 U.S. at 13-14. As to the origin of rule 10b-5, *see generally* 1 A. BROMBERG, SECURITIES LAW: FRAUD, SEC RULE 10b-5 § 2.2(410) (1971).

[13] The full text of the section reads:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> . . . .
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b)(1970).

[14] 404 U.S. at 12.

[15] *Id.* at 12-13.

[16] *See* Kaplan, *supra* note 6, at 926.

tries, Inc. v. Green,[17] decided on March 23, 1977, underscores this attitude quite forcefully. There, the Court, speaking through Mr. Justice White, stressed that for a claim to state a cause of action under rule 10b-5 there must be allegations of "manipulative or deceptive" conduct.[18] In adopting this attitude the Court rejected the position of the Court of Appeals for the Second Circuit that "'breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure'" could be treated as a violation of rule 10b-5.[19] The court of appeals had held that use of the Delaware short-form merger statute to effectuate a merger in a "going private" transaction without any business purpose gave rise to a claim under rule 10b-5,[20] even where the merger terms had been fully revealed to the shareholders.[21]

[17] 430 U.S. 462 (1977).

[18] *Id.* at 473-74. The Court remarked that "[t]he language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception." *Id.* at 473.

[19] *Id.* at 470.

[20] The "going private" transaction in *Green* had been effectuated in the following manner. Santa Fe Industries, Inc., through its wholly owned subsidiary, Santa Fe Natural Resources, had acquired 95% of the stock of Kirby Lumber Corp., a Delaware corporation. In 1974, a new corporation, Forest Products, Inc. was organized as a Delaware corporation and Santa Fe Natural Resources transferred its Kirby stock to Forest Products in exchange for all of Forest Product's capital stock. A merger of Forest Products into Kirby was then arranged pursuant to § 253 of the Delaware Corporation Law (the Delaware short-form merger statute), which permits a merger between a parent corporation and its subsidiary upon approval of the merger by the board of directors and shareholders of the parent corporation alone without the necessity of approval by the outside shareholders of the subsidiary, where the parent corporation owns at least 90% of the capital stock of the subsidiary. The merger plan called for the minority outside shareholders in Kirby to be paid $150 per share for their Kirby stock. A detailed financial information statement regarding the merger was sent, as required by the Delaware Corporation Law, to the minority shareholders in Kirby after consummation of the merger, along with notice of their right to seek an appraisal of their Kirby stock in the courts of Delaware if they were dissatisfied with the offer of $150 per share. Green, representing himself and other minority shareholders in Kirby, brought a suit under rule 10b-5 in the federal District Court for the Southern District of New York to have the merger set aside or to be awarded the fair value of the Kirby shares, claiming that the offer of $150 per share was far below the true worth of the stock and that the real purpose of the merger was to freeze out the minority shareholders. The district court dismissed the complaint for failure to state a cause of action. Green v. Santa Fe Indus. Inc., 391 F. Supp. 849 (S.D.N.Y. 1975).

[21] Green v. Santa Fe Indus., Inc., 533 F.2d 1283 (2d Cir. 1976). The seeds for treating rule 10b-5 as more than a "disclosure" rule were sown in Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968), *cert. denied,* 395 U.S. 906 (1969), when the Court of Appeals for the Second Circuit, in an en banc opinion, held that action by

In reversing this decision by the court of appeals, the Supreme Court first stressed the need to consider the relevant language of section 10(b), which refers to "manipulative or deceptive" conduct.[22] The Court concluded, as it had earlier in *Ernst & Ernst v. Hochfelder*,[23] where it imposed a scienter requirement for damage suits under rule 10b-5,[24] that the word "fraud" as used in rule 10b-5 to describe prohibited conduct must be read in the context of those two words.[25] Under this guideline, the Court was unable to find any deceptive conduct in the circumstances of the *Green* case, since there were no misrepresentations or nondisclosures involved.[26] Likewise, the

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the controlling shareholder of an oil company in securing the issue of a quantity of treasury stock of the company to the controlling shareholder at prices alleged to be below the true worth of the stock based on knowledge by the controlling shareholder of an oil discovery could be considered as constituting a fraudulent "act, practice or course of business" under rule 10b-5. 405 F.2d at 219-20. However, the court's position in this respect was weakened by its further recognition that there existed an element of deception in the case resulting from the fact that while the board of directors of the corporation was fully aware of the undisclosed information, the minority shareholders were not. *Id.* at 220. In 1972, a three-judge panel of the Second Circuit Court of Appeals read *Schoenbaum* as a "deception" case and held that when there had been adequate disclosure of the merger terms in a merger transaction, there was no basis for a rule 10b-5 suit claiming that the merger terms were unfair. Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972). However, when *Green* was before the Second Circuit, Judge Medina, speaking as one of a three-judge panel, observed that "[i]f there is no valid corporate purpose for the merger, then even the most brazen disclosure of that fact to the minority shareholders in no way mitigates the fraudulent conduct." 533 F.2d at 1292. Judge Medina accordingly held that the complaint in *Green* stated a cause of action. *Id.* at 1291. Judge Mansfield concurred in the result, *id.* at 1294, and Judge Moore dissented, *id.* at 1299.

Just prior to the decision by the Second Circuit in *Green*, another panel of judges in the Second Circuit upheld a complaint by minority shareholders in a "going private" merger transaction similar to that in *Green*, stating that a showing of misrepresentation or lack of disclosure was not necessary for a 10b-5 claim. Marshel v. AFW Fabric Corp., 533 F.2d 1277 (2d Cir. 1976). The Supreme Court granted certiorari in the *Marshel* case but vacated the judgment and remanded the case to the Court of Appeals for a determination whether the case had become moot. AFW Fabric Corp. v. Marshal, 429 U.S. 881 (1976). Plans for the merger involved in the case had been voluntarily dropped after Supreme Court review was sought. *See* SEC. REG. & L. REP., (BNA) No. 373, Oct. 13, 1976, at A-14.

[22] 430 U.S. at 472..

[23] 425 U.S. 185 (1976).

[24] In *Hochfelder*, the Court considered that the language "manipulative or deceptive" when used in conjunction with the words "device or contrivance" strongly suggested "that § 10(b) was intended to proscribe knowing or intentional misconduct." *Id.* at 197.

[25] 430 U.S. at 471-74.

[26] *Id.* at 474-77.

Court found no evidence of manipulative conduct within the meaning of that word as used in section 10(b), since the Court assumed that the term "manipulative" was used in that section as a word of art to refer to such practices as "wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity."[27]

Although the Court considered the language of the statute to be dispositive of the case, the Court went on in Part IV of its opinion to suggest additional considerations which it felt weighed heavily against permitting a cause of action under rule 10b-5.[28] The Court first noted that it was dealing with an implied cause of action for violations of section 10(b) rather than with a remedy expressly provided by Congress,[29] and that the Court had adopted the position that "a private cause of action under the antifraud provisions of the Securities Exchange Act should not be implied where it is 'unnecessary to ensure the fulfillment of Congress' purposes' in adopting the Act."[30] Since the Court considered the fundamental purpose of the Act to be to implement a policy of full disclosure, the Court concluded that "once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute."[31]

A second factor which the Court thought warranted consideration in determining whether Congress intended to create a federal cause of action under section 10(b) for conduct related to the "fairness" of a transaction was whether the complaint was one traditionally concerned with state law.[32] Noting that the Delaware legislature had provided minority shareholders with the appraisal remedy when they objected to the treatment accorded them in short-form mergers,[33] the Court considered it

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[27] *Id.* at 476.

[28] *Id.* at 477-80. Mr. Justice Blackmun and Mr. Justice Stevens, in separate concurring opinions, expressed their concern as to the implications of Part IV of the Court's opinion, particularly since that portion of the Court's opinion was not necessary to the decision in the case. *Id.* at 480-81. Mr. Justice Brennan dissented. *Id.* at 480.

[29] *Id.* at 477.

[30] *Id.*

[31] *Id.* at 478.

[32] *Id.*

[33] *Id.* The appraisal remedy refers to the right conferred by modern corporation statutes on dissenting shareholders, in connection with certain types of corporate

appropriate to refer the complaining shareholders in *Green* to their remedy under state law.[34] The Court added that relegating the plaintiffs to state law was particularly important in cases of this kind since otherwise it might prove impossible to contain rule 10b-5, due to the difficulty of distinguishing "going private" transactions from other types of securities transactions involving fiduciary self-dealing.[35] This, thought the Court, could result in a widely expanded class of plaintiffs, producing the danger of vexatious litigation that the Court had spoken of earlier in *Blue Chip Stamps v. Manor Drug Stores*,[36] in which it had approved the purchaser-seller standing requirement for plaintiffs in rule 10b-5 damage suits.[37] The Court said that "[a]bsent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overriden."[38] In this respect, the Court added, it was adhering to its position, previously asserted in the *Bankers Life* case, that it did not consider Congress to have intended by section 10(b) "'to regulate transactions which constitute no more than internal corporate mismanagement.'"[39]

Perhaps none of the recent Supreme Court decisions under the federal securities acts have as much potential for reestablishing the supremacy of state law in the area of corporate managerial responsibility as the decision in *Green*.[40] Certainly,

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changes, to be paid the fair value of their stock. *See* 13 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5906.1 (rev. perm. ed. 1970). The Delaware short-form merger statute gives such an appraisal remedy to dissenting shareholders in the subsidiary corporation. DEL. CODE tit. 8, § 253(d) (1974). For similar provisions in the Kentucky Business Corporation Act, see KY. REV. STAT. §§ 271A.375, .400-.405 (Supp. 1976)[hereinafter cited as KRS].

[34] 430 U.S. at 478.

[35] *Id.*

[36] 421 U.S. 723 (1975).

[37] 430 U.S. at 478-79. The purchaser-seller standing requirement refers to the requirement, sometimes called the *Birnbaum* rule, that a plaintiff in a rule 10b-5 suit be a purchaser or seller of stock. The *Birnbaum* standing requirement had its origins in Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

[38] 430 U.S. at 479.

[39] *Id.*

[40] The Court recognized that there might be a need for federal regulation of "going private" mergers such as involved in *Green*, but cautioned that such regulation should

the decision will help to reinforce a statement made by Judge Stanley Fuld of the New York Court of Appeals a few years ago that "the primary source of the law in this area ever remains that of the State which created the corporation."[41] On the other hand, the impact of the *Green* decision on federal law should not be overstated. In *Green,* Mr. Justice White explicitly recognized the rather impressive line of lower federal court cases upholding suits under rule 10b-5 based on the presence of deceptive conduct resulting from misrepresentations or nondisclosures.[42] The continued vitality of these cases would still leave federal law available in many situations where majority interests can be found to have been less than completely candid with minority shareholders when negotiating significant corporate transactions in which the majority have a personal self-interest.[43]

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not come from judicial extension of § 10(b) and rule 10b-5 to "cover the corporate universe." *Id.* at 480.

In a significant recent state law decision, the Supreme Court of Delaware held that a corporate merger consummated for the sole purpose of cashing-out minority shareholders constitutes a violation of the fiduciary obligations which majority shareholders owe to minority shareholders despite the fact that the merger complied with all the required procedural steps under Delaware law. Singer v. Magnavox Co., SEC. REG. & L. REP. (BNA), No. 422, Oct. 5, 1977, at E-1 (Del. 1977). Subsequently, the same court held that a corporate merger brought about by a majority shareholder primarily to facilitate long-term debt financing on its part did not constitute a violation per se of its fiduciary duty to the minority shareholders as expressed in *Singer* even though the merger accomplished a cash-out of the minority. Tanzier v. Int'l Gen. Indus., Inc., 379 A.2d 1121 (Del. 1977).

[41] Diamond v. Oreamuno, 248 N.E.2d 910, 915, 301 N.Y.S.2d 78, 85 (1969).

[42] 430 U.S. at 475 n.15.

[43] *See, e.g.,* Goldberg v. Meridor, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,162 (2d Cir., Sept. 8, 1977), *cert. denied,* SEC. REG. & L. REP. (BNA) No. 441, Feb. 21, 1978 at A-17. Commenting on the continued vitality of the Second Circuit decision in Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968), *cert. denied,* 395 U.S. 906 (1969), after *Green,* Judge Friendly observed:

> *Schoenbaum,* then, can rest solidly on the now widely recognized ground that there is deception of the corporation (in effect, its minority shareholders) when the corporation is influenced by its controlling shareholder to engage in a transaction adverse to the corporation's interests (in effect, the minority shareholders' interests) and there is nondisclosure or misleading disclosures as to the material facts of the transaction.

Goldberg v. Meridor, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,162, at 92,265.

Judge Friendly also commented in *Meridor* that the requirement of full disclosure should not be interpreted to mean that insiders must "characterize conflict of interest transactions with pejorative nouns or adjectives." *Id.* at 92,266 n.8. Accordingly, the federal District Court for the Southern District of New York has held that a share-

B. *Tender Offers*

The interest in the law pertaining to tender offers has increased dramatically in recent years, first as the result of the enactment by Congress in 1968 of the Williams Act[44] regulating tender offers at the federal level,[45] and more recently as the result of the proliferation of state "takeover" laws[46] enacted by state legislatures to control tender offers at the state level.[47]

The first case to be considered by the Supreme Court of the United States under the Williams Act was *Piper v. Chris-Craft Industries, Inc.*,[48] decided on February 23, 1977. This case grew out of the tender offer contest waged between Chris-Craft Industries and Bangor Punta Corporation for control of Piper Aircraft Corporation, which Bangor Punta ultimately won when it acquired over fifty percent of the Piper stock.[49] While the competing tender offers were pending, Chris-Craft brought a suit against Bangor Punta in the United States District Court for the Southern District of New York seeking damages and injunctive relief.[50] Although Chris-Craft was unsuccessful in its efforts to obtain injunctive relief, it was successful after several years of litigation in securing a damage judgment against not only Bangor Punta but also Piper Aircraft and First Boston Corporation, Piper's investment advisor and underwriter for Bangor Punta securities.[51] The judgment was based on viola-

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holder's allegation of deception under *Green* must allege more than a mere failure to disclose the "unfairness" of a transaction. Goldberger v. Baker, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,203 (S.D.N.Y., Oct. 20, 1977).

[44] Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454, amending Securities Exchange Act §§ 12-14, 15 U.S.C. §§ 78 l-n.

[45] *See* Brown, *The Scope of the Williams Act and Its 1970 Amendments*, 26 BUS. LAW. 1637 (1971).

[46] The Kentucky General Assembly adopted such a takeover law in 1976. *See* KRS §§ 292.560 *et seq.* For a general discussion of this legislation, see Ham, *Kentucky Law Survey—Corporations*, 65 KY. L.J. 255, 278-83 (1976).

[47] *See generally* Langevoort, *State Tender-Offer Legislation: Interests, Effects, and Political Competence*, 62 CORN. L. REV. 213 (1977). It is significant that a federal district judge in Texas has held that the Idaho takeover statute violates the commerce clause of the United States Constitution and is preempted by the Williams Act. Great W. United Corp. v. Kidwell, 439 F. Supp. 420 (N.D. Tex. 1977).

[48] 430 U.S. 1 (1977).

[49] *Id.* at 9.

[50] *Id.*

[51] The several stages of the litigation, from the filing by Chris-Craft of its initial suit on May 22, 1969, to the final court of appeals decision on April 11, 1975, assessing damages, is traced by the Supreme Court in the initial portion of its opinion. *Id.* at 9-

tions of section 14(e) of the Securities Exchange Act of 1934,[52] which prohibits fraudulent conduct in connection with the making of a tender offer.[53]

A threshold question faced by the Court in the *Piper* litigation was whether a defeated tender offeror has standing to sue under section 14(e).[54] The Court of Appeals for the Second Circuit had decided that such a tender offeror does have the requisite standing to complain,[55] and that a claim for damages on the part of Chris-Craft had been established.[56] The Supreme Court, speaking through Chief Justice Burger, reversed the judgment of the court of appeals, holding that a tender offeror does not have standing to sue for damages under section 14(e).[57] The Court referred to its reasoning in *J. I. Case Co. v. Borak*,[58] in which it had implied a private cause of action in favor of a shareholder under section 14(a) of the Securities Exchange Act,[59] dealing with the solicitation of proxies.[60] In *Borak* the Court had stressed the need for implying such a cause of action

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21. The litigation was the subject of a feature article in Fortune Magazine. *See* Guzzardi, *The Casualties Were Staggering in the Battle for Piper Aircraft*, FORTUNE, April 1976, at 90.

[52] 15 U.S.C. § 78n(e) (1970).

[53] The section provides:

> It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation.

Id.

[54] The district court did not pass on the § 14(e) standing issue, since it found no merit in Chris-Craft's claims. *See* Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 337 F. Supp. 1128 (S.D.N.Y. 1971)(opinion by Pollack, J.).

[55] Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 358 (2d Cir. 1973).

[56] *Id.* at 364-73.

[57] 430 U.S. at 42. In many ways this decision by the Supreme Court was a vindication for Judge Pollack, who, in his opinion as district judge, had shown a certain disdain for allowing professional businessmen caught in the throes of a contest for corporate control to avail themselves of laws enacted for the benefit of the unsophisticated investor. 337 F. Supp. at 1131.

[58] 377 U.S. 426 (1964).

[59] 15 U.S.C. § 78n(a) (1970).

[60] Section 14(a) makes it unlawful for any person to solicit proxies in respect to a registered security in contravention of such rules and regulations as the SEC may prescribe "as necessary or appropriate in the public interest or for the protection of investors." *Id.*

in order to further the congressional purposes in enacting the section, among which it found to be the protection of investors.[61] Finding a similar purpose in the legislative history of the Williams Act, the Court did not believe "that Congress contemplated a private cause of action for damages by one of several contending offerors against a successful bidder or by a losing contender against the target corporation."[62] The Court concluded that it was entirely appropriate to relegate the tender offeror to available remedies under state law to the extent that the offeror seeks damages for having lost an opportunity to compete for control of another corporation.[63] This latter conclusion by the Court in *Piper* seems particularly significant since it reflects an attitude similar to that which the Court

[61] 377 U.S. at 432. The Court said that while the language of § 14(a) made no reference to a private right of action, "among its chief purposes is 'the protection of investors,' which certainly implies the availability of judicial relief where necessary to achieve that result." *Id.*

[62] 430 U.S. at 35.

[63] *Id.* at 40-41. The Court considered this conclusion to be consistent with its opinion in Cort v. Ash, 422 U.S. 66 (1975). There, in determining whether a private remedy could properly be implied in a statute which made no express provision for one, the Court considered whether the cause of action was "one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law." *Id.* at 78.

Mr. Justice Blackmun concurred in the judgment reached by the Court in *Piper* but only on the basis that he did not believe that the alleged violations of the securities laws by the defendants caused injury to Chris-Craft, since it did not appear that Chris-Craft would have necessarily been able to secure control of Piper even if the alleged violations had not occurred. He agreed, however, with the dissenting opinion of Mr. Justice Stevens that Chris-Craft at least had "standing" to bring a suit under § 14(e). 430 U.S. at 48-53.

In his dissenting opinion, in which Mr. Justice Brennan concurred, Mr. Justice Stevens reasoned that since in both proxy and tender offer contests the remedy which will most effectively deter violations of the statute is the private damage action, the remedy, when implied to ensure full compliance with the statute, must be available to the litigants who are most vitally interested in effective enforcement. The potential litigants who have the most to gain from enforcement of the statute, he observed, and the most to lose if its provisions are ignored, are the rival contestants. So, he concluded, "[o]nce one recognizes that Congress intended to rely heavily on private litigation as a method of implementing the statute, it seems equally clear that Congress would not exclude the persons most interested in effective enforcement from the class authorized to enforce the new law." *Id.* at 62. He also expressed the view that he did not consider *Cort v. Ash, supra,* to preclude standing to tender offerors under § 14(e). He pointed out that "protection of tender offerors is not only consistent with protection of shareholders" but "[i]t is also indispensible to protecting shareholders." 430 U.S. at 68. In his opinion, he said, "the most realistic deterrent to fraud on shareholders is a damages suit brought by the opposition in the tender contest." *Id.*

expressed one month later in *Santa Fe Industries, Inc. v. Green,*[64] wherein the Court again referred to the need for federal law to avoid entrenching on areas of concern traditionally considered to be the domain of state law.[65] Furthermore, the restrictive position taken by the Court as to standing to sue under section 14(e) is consistent with its similar restrictive holding as to standing under section 10(b) and rule 10b-5 in the *Blue Chip Stamps* case.[66]

Actually, however, the opinion of the Court in *Piper* is severely limited in a number of respects. In the first place, the Court made it clear that it was considering only the standing of a tender offeror suing for damages in its capacity as a takeover bidder under section 14(e).[67] The Court added that it was not considering whether shareholder-offerees, the class protected by section 14(e), had an implied cause of action under that section, or whether the target corporation had standing to sue.[68] The Court also indicated that it was intimating no view as to whether a suit in equity for injunctive relief, as distinguished from an action for damages, would lie in favor of a tender offeror under section 14(e).[69] Finally, the Court said that it was "unnecessary to consider the Court of Appeals' holdings with respect to scienter, causation, the calculation of damages, the imposition of joint and several liability, the liability of underwriters in § 14(e) damage actions, and the award of prejudgment interest."[70] Thus, the Court has so far avoided coming to grips with the kinds of substantive issues relating to the application of section 14(e) that it has dealt with under other provisions of the Securities Exchange Act, particularly section 10(b) and rule 10b-5.[71] In view, however, of the popularity of

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[64] 430 U.S. 462 (1977).

[65] Id. at 478-79.

[66] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

[67] 430 U.S. at 42 n.28.

[68] *Id.*

[69] *Id.* at 47 n.33.

[70] *Id.* at 47.

[71] It is interesting to note in this regard that the court of appeals in *Piper* considered the controlling principles in determining § 14(e) violations to be the same as those controlling violations of rule 10b-5. 480 F.2d at 362. The court said, "[T]he underlying proscription of § 14(e) is virtually identical to that of Rule 10b-5 . . . . In determining whether § 14(e) violations were committed in the instant case, we shall follow the principles developed under Rule 10b-5 regarding the elements of such violations." *Id.*

the tender offer approach to corporate takeovers, that day may not be far off.[72] In the meantime, it is evident from decisions such as *Piper* that a majority of the present Court believe that it is desirable to restrict closely the class of litigants entitled to the benefits of the antifraud provisions of the federal securities acts.[73]

C. *Insider Trading*

Despite the recent efforts of the Supreme Court to contain rule 10b-5, there remains a wide variety of situations to which the rule can be made applicable.[74] One of these involves trading by insiders in the stock of their corporation on the basis of undisclosed material inside information.[75] Where such trading

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[72] Such review may be hastened by the increased interest which the Supreme Court has shown in recent years in accepting securities cases for review. Commenting on the defendant-oriented construction which the Court has been giving to the scope and coverage of the federal securities laws in the last four years and the dramatic change this has produced in the availability of these laws to the investing public, one writer has noted that "the depth and sweep of this change have been particularly extraordinary when one considers the short period of time involved." Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977).

[73] One of the concerns that has led to this restrictive attitude has been the fear of otherwise encouraging and fostering vexatious litigation, which may, according to Mr. Justice Rehnquist, writing for the majority in *Blue Chip Stamps*, "frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740 (1975).

[74] Judge Collins J. Seitz, now Chief Judge of the Third Circuit Court of Appeals and a former chancellor in the Delaware state courts, made the following perceptive observation at the Airlie House Symposium:

> I think it is important to keep in mind that for over 99 percent of all the cases in the Courts of Appeals of this country, one percent are ever reviewed on the merits by the Supreme Court, and indeed, even less than that. There are built-in limitations on the ability of the United States Supreme Court to review the ingenuity of some 80 or 90 circuit court judges when addressing situations which they feel may cry out for redress.

Proceedings, The Airlie House Symposium, supra note 2, at 1024-25.

[75] The case which firmly established rule 10b-5 as an insider trading rule was the well-known *Texas Gulf Sulphur* case. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). The SEC brought an enforcement action against Texas Gulf Sulphur and 13 individual defendants claiming that the individual defendants had violated rule 10b-5 by buying Texas Gulf stock at a time when they possessed information regarding a major ore discovery by the company which had not yet been publicly announced. It was in this case that the court set forth the "disclose or abstain" rule for insiders. Judge Waterman, speaking for a majority of the court, commented that "anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in

takes place in the context of a closely-held corporation on a face-to-face basis, there has been little doubt as to the right of those deceived to sue for damages under the rule.[76] However, when such trading activity occurs on the anonymous public market, it has not been clear whether those trading on the other side of the market from the insiders should be allowed to bring private civil damage suits.[77]

The recent Sixth Circuit case of *Fridrich v. Bradford*[78] provides an excellent example of the judicial concern for damage actions of this kind under rule 10b-5.[79] In *Fridrich,* one of the defendants, J. C. Bradford, Jr., purchased 1,225 shares of common stock in Old Line Life Insurance Company on April 27, 1972, based on inside information concerning a proposed merger of Old Line with another company.[80] He sold these shares on July 27, 1972, at a profit of $13,000.[81] On November 10, 1972, the SEC filed a rule 10b-5 enforcement action against

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order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed." 401 F.2d at 848.

[76] *See, e.g.,* Kardon v. Nat'l Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947).

[77] *See* Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5,* 65 COLUM. L. REV. 1361, 1379 (1965). Professor Painter remarked:

> The boundless scope of potential liability, by a class action or otherwise, is enough to make the whole question of civil liability in this area controversial. For failing to disclose relevant information during the course of a single transaction in which he purchased a limited number of shares, an insider could become virtually an insurer of the future losses suffered by all who sold at about the same time. If several purchases were made, the extent of liability on a per share basis would correspond with the volume of trading during the period in question. If Section 16(b) has been criticized as being "arbitrary" and "penal," an application of Section 10(b) in the manner suggested above would be nothing short of confiscatory. Yet, any other approach would, of necessity, be arbitrary in its choice of persons accorded a right to recovery.

Id.

The reference by Professor Painter to "Section 16(b)" is to § 16(b) of the Securities Exchange Act of 1934, which provides for corporate recovery of any profits realized by a director, officer, or 10% beneficial owner of a corporation's stock from trading activities in such stock within a six-month period. 15 U.S.C. § 78p(b) (1970).

[78] 542 F.2d 307 (6th Cir. 1976), *cert. denied,* 429 U.S. 1053 (1977).

[79] For a discussion of alternative remedies to the problem of insider trading in publicly-held corporations, see Ratner, *Federal and State Roles in the Regulation of Insider Trading,* 31 BUS. LAW. 947, 954-60 (Special Issue, February 1976).

[80] 542 F.2d at 310.

[81] *Id.* at 311.

Bradford, Jr. and certain other named defendants, who were also charged with insider trading violations involving Old Line stock.[82] The other named defendants included J. C. Bradford, Sr., who in 1961 had organized a syndicate to purchase a controlling block of Old Line stock and who was the key figure in the Old Line merger negotiations; J. C. Bradford & Co., a stock brokerage firm which served as a market-maker for Old Line stock and in which Bradford, Sr. and his son Bradford, Jr..were managing partners; J. C. Bradford & Co., Inc., a corporation wholly owned by the partners of J. C. Bradford & Co.; and Life Stock Research Corp., a registered investment company, eighty-one percent of whose voting capital stock was owned by J. C. Bradford & Co., Inc.[83] As the result of a consent decree entered in the SEC action, Bradford, Jr. was required to disgorge his $13,000 profit and was permanently enjoined, along with the other defendants, from any further violations of section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5.[84] Later, a group of plaintiffs, who were owners of Old Line stock and who had sold their Old Line stock in June, 1972, brought a civil action under section 10(b) and rule 10b-5 against Bradford, Jr. and the other defendants named in the SEC proceedings.[85] The district court awarded a judgment in favor of the plaintiffs against the defendants, including Bradford, Jr., in the amount of $361,186.75.[86] This sum represented the difference between the price each plaintiff received for his shares sold during the period of nondisclosure and the highest value reached by Old Line stock within a reasonable time after the disclosure of the information wrongfully withheld.[87]

The court of appeals reversed the decision of the district court and remanded the case for entry of judgment for the defendants.[88] The court took the position that plaintiffs in rule 10b-5 damage actions must establish the causal connection between the defendants' misconduct and their loss and that in *Fridrich* the defendants' conduct, including that of Bradford,

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[82] *Id.*
[83] *Id.* at 309.
[84] *Id.* at 308, 311.
[85] *Id.* at 312.
[86] *Id.* at 313.
[87] *Id.* at 312-13.
[88] *Id.* at 323.

Jr., caused no injury to plaintiffs since defendants purchased no stock from plaintiffs and their acts of trading had no effect on the decision of the plaintiffs to sell.[89] The concern which the court of appeals had for the crushing liability which could result by extending the reach of section 10(b) and rule 10b-5 to anonymous market transactions in private damage actions was underscored by the court in the following remarks:

> The key issue, as we see it, is not whether the proscriptions of § 10(b) and Rule 10b-5 should encompass open market transactions, which they should, but whether the civil remedy must invariably be coextensive in its reach with the reach of the SEC, which under the Act, was designated by the Congress as the primary vehicle of its enforcement. We reject such a view where its application leads us inexorably to an unjust and unworkable result. By so extending the liability of defendants here beyond that which had already been imposed through the SEC enforcement action, we believe we would be doing violence to the intent of the statute and rule, creating a windfall for those fortuitous enough to be aware of their nebulous legal rights, and imposing what essentially must be considered punitive damages almost unlimited in their potential scope.
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> Where private civil actions under Rule 10b-5 have been employed in essentially face-to-face situations, the potential breadth of the action was usually contained. However, extension of the private remedy to impersonal market cases where plaintiffs have neither dealt with defendants nor been influenced in their trading decisions by any act of the defendants would present a situation wholly lacking in the natural limitations on damages present in cases dealing with face-to-face transactions . . . .[90]

The *Fridrich* decision stands in sharp contrast to an earlier decision reached by the Second Circuit Court of Appeals in *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[91] There, the Merrill Lynch brokerage firm had disclosed to a group of large institutional investors certain unfavorable financial information it possessed regarding the earnings of Douglas Aircraft Corporation before the information had been released to the

[89] *Id.* at 318.
[90] *Id.* at 320-21.
[91] 495 F.2d 228 (2d Cir. 1974).

public by Douglas Aircraft.[92] The institutional investors took immediate advantage of this information and sold their Douglas Aircraft shares on the New York Stock Exchange.[93] The court of appeals held that the institutional investors were liable to all public investors who were on the market buying Douglas Aircraft stock during the same period that the institutional investors were selling their Douglas Aircraft stock.[94] The court considered that the institutional investors had breached a duty to the plaintiff investors by trading in Douglas Aircraft stock without disclosing the material inside information they possessed and that under the decision of the Supreme Court of the United States in *Affiliated Ute Citizens v. United States,*[95] all that was necessary for the plaintiff investors to show in order to establish the element of causation was that the information withheld was material in the sense that a reasonable investor might have considered it important in the making of his investment decision.[96] In reaching this result the court was well aware

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[92] *Id.* at 232. Merrill Lynch had received this information as a result of its position as the managing underwriter for a proposed offering of debentures by Douglas Aircraft. *Id.*

[93] *Id.* As a result of these actions by Merrill Lynch and the institutional investors, the SEC instituted an administrative proceeding against Merrill Lynch and the institutional investors. Merrill Lynch submitted an offer of settlement which was accepted. The Commission, however, pursued its case against the institutional investors and ultimately approved a determination by a hearing examiner that the institutional investors be censored for violation of the federal securities laws. *In re* Investors Management Co., Securities and Exchange Act Release No. 9267 (July 29, 1971).

[94] 495 F.2d at 237.

[95] 406 U.S. 128 (1972).

[96] 495 F.2d at 238. In *Affiliated Ute* the complaint charged that two bank employees induced certain members of the Ute Indian tribe to sell shares of stock held by them to the employees and others, without disclosing to them that they had created a secondary market in the stock on which the stock was sold at a higher price. In response to the contention that the plaintiffs should be required to prove their reliance on the information withheld, the Court remarked:

> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.

406 U.S. at 153-54.

The court in *Fridrich* considered the language of *Affiliated Ute* to be inapposite to anonymous market transactions. The court said:

> It was shown in *Affiliated Ute* that the defendant bank employees had engaged in prior business dealings with the plaintiff Indians. They entered

of the damage problem resulting from imposing liability on the institutional investors but left to the district court on remand the assessment of appropriate damages.[97]

The decision reached by the court in *Fridrich* eliminates the damage issue left open in *Shapiro* but, as one commentator has observed, "[s]ince proof of causation in nondisclosure cases involving impersonal markets is almost impossible, this position virtually eliminates recoveries by investors against insiders in private 10b-5 actions."[98] The *Fridrich* decision also

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> into a deliberate scheme to induce the plaintiffs to sell their stock without disclosure of material facts which would have influenced the decision to sell. The resulting sales were a direct result of the scheme.
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> . . . .
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> Here, unlike *Affiliated Ute*, defendants did not perpetrate any scheme to induce defendants (sic) to sell their stock. Plaintiffs and defendants here had no relationship whatever during the period in question. The plaintiffs in *Affiliated Ute* had a right to expect that the defendant bank officials would fully disclose all material information concerning the stock while inducing them to sell. When defendants did not make full disclosure, they breached Rule 10b-5 and became liable for plaintiffs' foreseeable damages. The type of relationship existing between plaintiffs and defendants in *Affiliated Ute* is totally absent here.

Fridrich v. Bradford, 542 F.2d at 319-20.

[97] 495 F.2d at 241. The court said:

> In leaving to the district court the fashioning of appropriate relief, including the proper measure of damages, we are not unmindful of the arguments pressed upon us by all defendants that the resulting judgment for damages may be very substantial in amount—in the words of defendants' counsel, a "Draconian liability." This is an additional reason for leaving to the district court the appropriate form of relief to be granted—a determination that can best be made after an evidentiary hearing and on the basis of appropriate findings of fact.

Id. at 242.

[98] Comment, 30 VAND. L. REV. 122, 128 (1977). In a concurring opinion which he wrote in the *Fridrich* case, Judge Celebrezze took the position that under the "disclose or abstain" rule of the *Texas Gulf Sulphur* case, "[t]he duty of disclosure is owed to the class of investors trading contemporaneously with the insider and it is only this group who are the proper beneficiaries of the relaxed causation standard of *Affiliated Ute.*" 542 F.2d at 326. Since the plaintiffs did not sell their Old Line stock until several weeks after the defendants had ceased their purchases of such stock, Judge Celebrezze agreed with the court's reversal of the lower court decision. *Id.* at 327.

It is interesting to note that when the *Shapiro* case went back to the district court on remand from the Second Circuit Court of Appeals, the district court treated as eligible plaintiffs not only those who purchased Douglas Aircraft stock at the same time that the institutional investors were selling their Douglas stock but also those who purchased up to the time the undisclosed earnings information was publicized. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,377, at 98,877-78 (S.D.N.Y. 1975). In his concurring opinion in ignores one of the assumed aims of rule 10b-5, namely, to protect investors from imbalances in trading opportunities on the public markets resulting from the possession of nondisclosed information by insiders.[99] On the other hand, the potentially unlimited liability faced by insiders under the *Shapiro* decision makes that decision likewise unappealing absent some definable ceiling on allowable damages.[100] One suggested solution is to limit the damages recoverable by plaintiffs in anonymous market transactions to the amount which represents the profit enjoyed by the defendant insiders from their trading activity.[101] While this solution also has its weaknesses,[102] it at least preserves the private civil damage action as an effective tool for policing insider trading in the open market, while at the same time protecting insiders from possible catastrophic damage awards.[103]

Fridrich, Judge Celebrezze questioned whether this extended liability would be appropriate in a "straight insider trading" situation such as in *Fridrich* as distinguished from a "tipping" case such as in *Shapiro*, when any informational imbalance in the market resulting from a selective leakage of information might continue even after the wrongdoing parties ceased their trading. 542 F.2d at 327.

[99] *See*, for example, the statement by Judge Waterman in *Texas Gulf Sulphur* that "the Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

[100] *See* Comment, *supra* note 98, at 129. In *Fridrich*, Judge Engel, who wrote the majority opinion, pointed out that if all of the persons who sold their shares of Old Line stock on June 13, 14, and 15, 1972, the days when the plaintiffs sold their Old Line stock, had joined in the lawsuit, Bradford, Jr.'s potential damage liability would have amounted to approximately $800,000. If the class of plaintiffs were increased to include all investors who sold between April 21, 1972, when trading activity in Old Line stock started, and June 29, 1972, the date of the first public announcement of the proposed Old Line merger, Judge Engel calculated that the damages could have reached approximately $3,700,000. Or if the class of plaintiffs were extended to November 20, 1972, the date the merger was approved by the SEC, damages could have reached in excess of $7,000,000. 542 F.2d at 321 n.29.

[101] *See* ALI FED. SEC. CODE § 1402(f)(2)(B)(Tent. Draft No. 2, March 1973).

[102] One problem with limiting damages to the profits secured by the insiders from their trading activities is that if there are a large number of individual plaintiffs and the total recovery is prorated among them, the amount received by each individual plaintiff may be so small as to provide little incentive for the bringing of such actions, thereby eliminating the private damage action as an effective deterrent to insider trading. However, as one commentator put it, "the actions would be brought—if only for the attorney's fees just as they are now brought under section 16(b)." Note, *Damage to Uninformed Traders for Insider Trading on Impersonal Exchanges*, 74 COLUM. L. REV. 299, 314 (1974).

[103] *See* Comment, *supra* note 98, at 130. For another viewpoint as to how best to control the damage award in private suits involving anonymous market transactions,

II. STATE CORPORATION LAW

A. *Corporate Entity*

In the realm of state corporation law, perhaps the case of most interest from the standpoint of Kentucky law during the period covered by the present Survey is *Poyner v. Lear Siegler, Inc.*[104] *Poyner* involved application by the Sixth Circuit Court of Appeals of the Kentucky law pertaining to disregard of the corporate entity in the setting of a products liability suit.[105]

The volume of litigation in personal liability cases involving attempts to "pierce the corporate veil" to reach corporate owners has been considerable over the years.[106] However, the courts have differed considerably in the strictness or leniency with which they have viewed the entity concept and as to the particular factors that justify looking through the corporation to its owners for settlement of third party claims.[107] In *Poyner* the Sixth Circuit Court of Appeals accepted the viewpoint that the Kentucky courts have evinced "a general aversion for *any* disregard of the corporate entity,"[108] and approached *Poyner* with this attitude in mind.[109]

The *Poyner* case arose as a result of injuries suffered by Poyner, a sixteen-year-old boy, when a .22 caliber pistol with which he and a friend were playing accidentally discharged.[110] The gun had been manufactured by Erma Werke, a West German company that was a wholly owned subsidiary of Lear Sie-

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see Rapp, *Fridrich v. Bradford and the Scope of Insider Trading Liability Under SEC Rule 10b-5: A Commentary,* 38 OHIO ST. L.J. 67 (1977), in which the author recommends adoption of the contemporaneous trading requirement used by Judge Celebrezze in his concurring opinion in *Fridrich* as a rational limitation on recovery in suits of this kind.

[104] 542 F.2d 955 (6th Cir. 1976).

[105] The entity concept is basic to the organization and structure of the American business corporation. One of the principal advantages sought through incorporation is the insulation which it provides from the debts of the business enterprise. This insulation flows from the concept of the corporation as a separate entity whose rights and obligations are separate and distinct from those of the individuals who compose it. *See* BALLANTINE, CORPORATIONS § 118 (rev. ed. 1946).

[106] *See* Hamilton, *The Corporate Entity,* 49 TEX. L. REV. 979 (1971).

[107] *See* 1 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 41.3 (rev. perm. ed. 1974).

[108] Campbell, *Limited Liability for Corporate Shareholders: Myth or Matter-of-Fact,* 63 KY. L.J. 23, 48 (1975).

[109] 542 F.2d at 958.

[110] *Id.* at 957.

gler, Inc., a Delaware corporation.[111] Poyner filed an action for damages against Erma in the United States District Court for the Western District of Kentucky under the Kentucky long-arm statute,[112] claiming that his injuries had been caused by a defect in the pistol, and he recovered a default judgment.[113] Since Erma had no assets in the United States and since enforcing the judgment against Erma in West Germany would have been expensive and time-consuming, Poyner filed a supplemental complaint against Lear Siegler to hold Lear Siegler liable for the judgment against Erma.[114] The court held that the corporate veil could be pierced and that Lear Siegler was bound by the original judgment.[115] The court noted that under West German law, Lear Siegler, as sole shareholder of Erma, had the right to interfere at any time in the affairs of the subsidiary; that the two members of Erma's advisory board were Lear Siegler personnel based in the United States; and that no formal meetings of that board had been held nor records of meetings kept.[116] From this the court concluded that Lear Siegler had exercised its control of Erma to adopt a strategy designed to frustrate recovery for injuries, regardless of the merits of products liability claims, and had thereby worked " 'an unfair hardship on Erma's foreseeable American creditors.' "[117] This, according to the court, called for ignoring the separate legal identity of Erma.[118]

The court of appeals reversed the lower court and held that the separate existence of the two corporations should not be disregarded.[119] The court of appeals considered that under Kentucky law a corporate entity can be disregarded only where the artificial corporate personality serves to shield individuals from legal responsibility for illegal or fraudulent acts,[120] and that

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[111] *Ia.*
[112] KRS § 454.210 (Supp. 1976).
[113] 542 F.2d at 957.
[114] *Id.*
[115] *Id.* at 958.
[116] *Id.* at 957.
[117] *Id.* at 958.
[118] *Id.*
[119] *Id.* at 961.
[120] *Id.* at 958. For a recent Kentucky case of this kind, see Dare To Be Great, Inc. v. Commonwealth, 511 S.W.2d 224 (Ky. 1974), noted in Ham, *Kentucky Law Survey, Corporations,* 63 KY. L.J. 739 (1975).

such a situation would result only where the existence of the corporation deprived the plaintiff of a remedy which he might otherwise have had.[121] The court pointed out that Lear Siegler's acquisition of control of Erma had not resulted in any material change in Erma's operations so as to deprive Poyner of any recourse he would otherwise have had for his injuries.[122] The court noted the position taken by courts in other jurisdictions, particularly California, recognizing that the corporate veil may be pierced if a corporation is undercapitalized.[123] However, even assuming such a doctrine could be extended to a defendant such as Lear Siegler which had not created an undercapitalized subsidiary but which had merely acquired a foreign subsidiary with no United States assets, the court was unwilling to accept this doctrine for Kentucky without a firmer recognition of the doctrine in the Kentucky case law, which it was unable to find.[124]

The concluding paragraph of the court's opinion underscores rather well the fluid nature of the entity concept in corporation law and the need perhaps for the Kentucky Supreme Court in an appropriate case to reconsider some of the older Kentucky precedents.[125] The court said:

> This is the sort of appealing case which might have led the Kentucky courts to reexamine the doctrine of limited liability, or at least to further limit its application. However, we must apply the law as it appears in existing Kentucky decisions. We believe that it would be an unprecedented extension of the Kentucky doctrine to disregard Erma's separate corporate existence in this case.[126]

[121] 542 F.2d at 959.

[122] *Id.* at 960.

[123] *Id.* at 958. For California cases stressing the importance of undercapitalization as a factor in disregarding the corporate entity, see Minton v. Cavaney, 364 P.2d 473, 15 Cal. Rptr. 641 (1961)(tort liability); Automotriz del Golfo de Cal. v. Resnick, 306 P.2d 1 (Cal. 1957)(contract liability). *Cf.* Walkovszky v. Carlton, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966)(tort liability); Bartle v. Home Owners Cooperative, Inc., 127 N.E.2d 832, 140 N.Y.S.2d 512 (1955)(contract liability). *See generally* 1 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 44.1 (rev. perm. ed. 1974).

[124] 542 F.2d at 958.

[125] *Id.* at 961.

[126] *Id.*

B. *Duty of Care*

Litigation in other areas of state corporation law continues at a steady pace in a myriad of contexts, which makes selection of any particular area for comment somewhat difficult. However, one area, that relating to the care that should be required of directors in the management of the corporate business entrusted to their charge, has been receiving increasing attention.[127] There has long been a common-law doctrine that directors must not be guilty of negligence in the discharge of their managerial duties,[128] but courts have not always made it clear by what standard this duty of care is to be measured.[129]

The generality of the concept is illustrated in *Atlantic Acoustical & Insulation Co. v. Moreira,*[130] a recent case from the Supreme Judicial Court of Maine. Moreira, one of the two fifty percent owners in a closely-held corporation and a director and officer of the corporation, was charged with dereliction in failing to apprise the company's accounting firm of certain adverse financial information which it was claimed would have affected the accounting firm's evaluation of the stock of the corporation.[131] The valuation was being made to provide a basis for one of the fifty percent owners to sell his stock back to the corporation and leave the business.[132] When the accounting firm announced its valuation of the stock, Moreira agreed with the other fifty percent owner to sell his stock to the corporation at the established price.[133] Moreira was paid partly in cash for his stock and partly by means of a promissory note for the balance, payable in two installments.[134] The corporation sued Moreira

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[127] *See Proceedings, ABA National Institute, Current Problems of Corporate Directors—Discharging Developing Responsibilities,* 31 BUS. LAW. 1219-1442 (Special Issue, March 1976). One of the speakers at this institute remarked, "A directorship is not a mere honorarium. Being a director today is serious business. It carries with it heavy responsibilities. No one should become or remain a director unless he is willing and able to give the time and effort necessary to discharge those responsibilities." Harris, *Directors of Industrial Companies: Special Problems,* 31 BUS. LAW. 1235, 1241 (Special Issue, March 1976).

[128] *See* 3 A.W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1029 at 11 (rev. perm. ed. 1975).

[129] *Id.* at 12.

[130] 348 A.2d 263 (Me. 1975).

[131] *Id.* at 264.

[132] *Id.* at 265.

[133] *Id.*

[134] *Id.*

shortly after the first installment on the note became due and succeeded in obtaining a temporary restraining order and later a preliminary injunction preventing Moreira from suing on the note.[135] In the subsequent trial on the merits, the trial judge ordered the action dismissed,[136] and this was affirmed on appeal.[137]

The court concluded that on the basis of the evidence presented there was nothing to suggest that Moreira had failed to discharge his obligation to exercise due care to protect the interests of the corporation.[138] Although the case was treated as one governed by general common-law principles, the court referred to the subsequent enactment by Maine of a statutory provision, part of the newly adopted Maine Business Corporation Act,[139] which stated that directors and officers of a corporation must discharge their duties "with that degree of diligence, care, and skill which ordinarily prudent men would exercise under similar circumstances in like positions."[140] This is a flexible standard, popular in other states as well,[141] which permits a court to take into account the circumstances of each case, including such things as the nature and size of the corporation and the role of the particular director.[142] Another standard, thought to be more strict, requires the director to discharge the duties of his office with that degree of care which ordinarily prudent men would exercise in their personal business affairs.[143]

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[135] *Id.* at 266.

[136] *Id.*

[137] *Id.* at 268.

[138] *Id.* at 267.

[139] ME. REV. STAT. tit. 13-A, §§ 101-1404 (1974).

[140] *Id.* at § 716.

[141] *See, e.g.,* N.Y. BUS. CORP. LAW § 717 (McKinney 1963).

[142] A revision note to § 717 of the New York Business Corporation Act, which adopts the "flexible duty" standard, says that "the adoption of the standard prescribed by this section will allow the court to envision the director's duty of care as a relative concept, depending on the kind of corporation involved, the particular circumstances and the corporate role of the director." Comment, N.Y. BUS. CORP. LAW § 717 (McKinney 1963).

[143] *See* Litwin v. Allen, 25 N.Y.S.2d 667, 678 (Sup. Ct. 1940). This was formerly the statutory standard in Pennsylvania. *See* Selheimer v. Manganese Corp. of America, 224 A.2d 634 (Pa. 1966).

Regardless of the particular standard used, directors have rarely been held on a charge of negligence alone,[144] a result which has caused some concern as to whether the law has been too lenient in its attitude toward the responsibilities which directors owe in the conduct of the corporate business.[145] On the other hand, as has also been observed, "a heightening of the level of care and diligence expected of boards of directors must be accompanied by a rational and comprehensible redefinition of the functions of boards of directors."[146] An attempt at such redefinition has been undertaken by the Committee on Corporate Laws of the American Bar Association in connection with its recent revision of section 35 of the Model Business Corporation Act,[147] which deals with the role and function of the board of directors in the heirarchy of corporate management.[148] Of particular interest in connection with this revision of section 35 was the addition to the section of an affirmative statement of the standard of care expected of corporate directors.[149] The Committee explains that this addition was made to section 35 in recognition of the growing trend to introduce such provisions in corporation statutes and in recognition of the desirability of promoting uniformity in the development by statute of the basis on which a director's performance should be judged.[150]

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[144] *See* Bishop, *Sitting Ducks and Decoy Ducks: New Trends in Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1095 (1968). As Professor Bishop said, "the search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack." *Id.* at 1099.

[145] *See* N. LATTIN, THE LAW OF CORPORATIONS § 78, at 274 (2d ed. 1971). Professor Lattin comments, "Courts have been far too lenient in their treatment of directors who do not direct under whatever rule they adopt as a test of liability." *Id.*

[146] Vagts, *Directors: Myth and Reality*, 31 BUS. LAW. 1227, 1232-33 (Special Issue, March 1976). *See generally* M. MACE, DIRECTORS: MYTH AND REALITY (1971).

[147] ABA-ALI MODEL BUS. CORP. ACT, Addendum B. (rev. ed. 1974)[hereinafter cited as MODEL ACT]. The Kentucky counterpart to § 35 of the Model Act, absent the recent revisions, is KRS § 271A.175 (Supp. 1976). Kentucky adopted the Model Act in substantial part in 1972. *See* Ham, *Kentucky Adopts a New Business Corporation Act*, 61 KY. L.J. 73 (1972).

[148] The standard operating procedure for corporations has been described as pyramidal in form, with the shareholders at the base voting on matters of major corporate concern, the board of directors at the next level setting the broad policies of the corporation, and the officers at the top executing the policies set by the board. *See* W. CARY, CASES AND MATERIALS ON CORPORATIONS 150 (4th ed. unabridged 1969).

[149] MODEL ACT § 35 (as revised)(second paragraph).

[150] Comment on Amendments to Sections 35 and 48 of the Model Business Corporation Act [hereinafter cited as Comment], MODEL ACT at 142. As a part of the

The basic standard adopted by the Committee is the flexible duty standard.[151] The new provision states that:

> [a] director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances.[152]

The Committee points out that the language of this provision was framed in terms of "care" and not, as in some existing statutes, such as Maine's, in terms of "diligence, care, and skill"[153] for the reason that it was not clear just what "skill" and "diligence" were expected to mean in relation to the performance of directors as distinguished from "care."[154] As they go on to say, skill, in the sense of technical competence in a particular field, has never been regarded as a qualification for the office of director, and, as to the concept of "diligence," that seems adequately covered and included within the concept of "care."[155] The revised section also contains provisions recognizing that directors have a right to rely on information and opinions supplied by others where such reliance is merited.[156] This reliance can relate to information supplied by officers and employees, or by persons with special expertise or competence such as attorneys or accountants, or by board committees.[157]

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overhaul of § 35, the Committee on Corporate Laws also approved changes in § 48, which deals with the liability of directors in certain cases (declaration of dividends, purchase by a corporation of its own stock, and distribution of assets in liquidation), to make that section consistent with the changes made in § 35. *See* Comment, *supra*, at 142. The Kentucky counterpart to § 48, without the changes, is KRS § 271A.240 (Supp. 1976).

[151] MODEL ACT § 35 (as revised).

[152] *Id.* Unlike other statutes, the Model Act does not include officers within the statutory standard. The Committee on Corporate Laws explains that since § 35 deals with management by the board of directors, it was thought inappropriate to include officers who were not also directors of the corporation. *See* Comment, *supra* note 150, at 144. The Committee recognized that while a non-director officer may be subject to a standard of care similar to that imposed on directors, the ability of the non-director officer to rely on information supplied by others may be more limited due to his closer association with corporate affairs. *Id.*

[153] ME. REV. STAT. tit. 13-A, § 716 (1974).

[154] Comment, *supra* note 150, at 143-44.

[155] *Id.* at 144.

[156] MODEL ACT § 35 (as revised)(second paragraph).

[157] *Id.* This portion of the revised section reads:

The special attention given to the right on the part of directors to rely on others results from a recognition of the inability of directors, especially if they are "outside" directors, to assume an active role in the daily operations of a large, complex business enterprise.[158] In further recognition of the supervisory role played by the modern board of directors, the Committee has changed the language of section 35 from providing that the business and affairs of a corporation shall be managed *by* the board of directors to providing that the business and affairs of a corporation shall be managed *under the direction of* a board of directors.[159] These recommended changes in the Model Business Corporation Act, if adopted in Kentucky and other Model Act jurisdictions, should help provide the "redefinition of the functions of boards of directors" necessary for the perfection of a viable standard of managerial conduct.[160]

> In performing his duties, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by:
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> (a) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented,
>
> (b) counsel, public accountants or other persons as to matters which the director reasonably believes to be within such person's professional or expert competence, or
>
> (c) a committee of the board upon which he does not serve, duly designated in accordance with a provision of the articles of incorporation or the by-laws, as to matters within its designated authority, which committee the director reasonably believes to merit confidence, but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted. A person who so performs his duties shall have no liability by reason of being or having been a director of the corporation.

[158] *See* Comment, *supra* note 150, at 142-43.

[159] MODEL ACT § 35 (as revised) (first paragraph). The section now reads, "All corporate powers shall be exercised by or under authority of, and the business and affairs of a corporation shall be managed under the direction of, a board of directors except as may be otherwise provided in this Act or the articles of incorporation . . . ."

[160] As the Committee on Corporate Laws explained the changes in § 35:

> Since the growth of the law in this dynamic corporate area will continue to come through judicial interpretation, it is hoped that this clarification of the statutory premise will assist the courts in recognizing more clearly the practicalities of accountability in the corporate model and thus permit the law to develop principles of responsibility and liability which more accurately recognize the proper role of the corporate director.

Comment, *supra* note 150, at 147.

C. *Quorum*

A recent Virginia case, *Levisa Oil Corp. v. Quigley,*[161] focuses attention on the question whether a quorum once established at a shareholders' meeting can be broken by the subsequent withdrawal of a portion of the shareholders from the meeting.[162] In *Quigley,* two shareholders owning a majority of the stock in the corporation did this to prevent the election of a board of directors which they feared would take action to divest them of their control.[163] The majority shareholders had made a motion to amend the bylaws of the corporation in certain respects, and when this was ruled out of order by the chairman of the meeting, had made a motion to adjourn the meeting, which was also ruled out of order.[164] After the withdrawal of the two majority shareholders from the meeting, the remaining minority shareholders proceeded to elect a board of directors of five persons, as provided for in the bylaws of the corporation, three of whom represented the minority interests.[165] These three then proceeded to meet and authorize a sale to one of the minority shareholders of a quantity of treasury stock of the corporation sufficient to divest the majority shareholders of their control.[166] The dominant majority shareholder brought a suit against the corporation and its minority shareholders to invalidate the election of directors and the subsequent action by these directors in issuing the treasury stock.[167] The court granted the relief requested,[168] and this was affirmed by the Supreme Court of Virginia.[169]

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[161] 234 S.E.2d 257 (Va. 1977).

[162] Corporation statutes customarily contain a section dealing with the quorum requirements for shareholder meetings. *See, e.g.,* KRS § 271A.160(Supp. 1976). Paragraph (1) of this section provides:

> Unless otherwise provided in the articles of incorporation, a majority of the shares entitled to vote, represented in person or by proxy, shall constitute a quorum at a meeting of shareholders, but in no event shall a quorum consist of less than one-third (1/3) of the shares entitled to vote at the meeting.

[163] 234 S.E.2d at 258.

[164] *Id.*

[165] *Id.* at 258-59.

[166] *Id.* at 259.

[167] *Id.*

[168] *Id.*

[169] *Id.* at 261.

The Virginia Supreme Court agreed with the lower court that the quorum at the shareholders' meeting was lost when the two majority shareholders left the meeting and that any business thereafter conducted was of no legal effect.[170] The Supreme Court found support for its position in the language of the Virginia corporation statute, which established the quorum requirement for shareholders' meetings as a majority of the shares entitled to vote,[171] and in the bylaws of the corporation, which spoke of a quorum for the transaction of business as constituting a majority of the shares issued and outstanding.[172] The inference the court derived from this latter statement in the bylaws was that no business was to be transacted at a shareholders' meeting unless shareholders holding the specified majority of shares were present.[173]

Actually, the cases are divided somewhat on the question whether, once a quorum has been obtained at a shareholders' meeting, it can be broken by subsequent withdrawals of shareholders from the meeting.[174] The Virginia Supreme Court in *Quigley* noted, however, that in some of the cases adopting the view that a quorum once established is not broken by subsequent withdrawals, the courts had emphasized that the shareholders who withdrew had done so arbitrarily or capriciously.[175] In *Quigley,* by way of contrast, the court did not believe that the two majority shareholders had withdrawn from the meeting without justification, despite the fact that it was argued that they could have achieved their ends by staying at the meeting

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[170] *Id.* at 259.

[171] VA. CODE § 13.1-31 (1973). The section provides as to quorum:

> Unless otherwise provided in the articles of incorporation, a majority of the shares entitled to vote, represented in person or by proxy, shall constitute a quorum at a meeting of stockholders, but in no event shall a quorum consist of less than one third of the shares entitled to vote at the meeting. . . . Less than a quorum may adjourn.

[172] 234 S.E.2d at 259-60. The bylaws provided, as quoted by the court:

> "A quorum for the transaction of business at any such meeting shall consist of a number of members representing a majority of the shares of stock issued and outstanding; but the stockholders present at any meeting, though less than a quorum, may adjourn the meeting to a future time."

Id. at 260.

[173] *Id.*

[174] *See* 5 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2013.1 (rev. perm. ed. 1976).

[175] *See, e.g.,* Hexter v. Columbia Baking Co., 145 A. 115 (Del. 1929); Commonwealth v. Vandegrift, 81 A. 153 (Pa. 1911).

and voting against the election of directors if they felt there was a scheme on the part of the minority to divest them of their control.[176] The court reasoned that there was nothing improper in the two shareholders, unversed in the intricacies of corporate or parliamentary procedure, choosing a defensive action which to them would best protect their majority interest in the corporation.[177]

The effect of withdrawal of shareholders on the status of a quorum once formed has been dealt with in some jurisdictions by statute.[178] Kentucky is such a jurisdiction, having added a paragraph to the Model Act section on quorum to take care of such a situation.[179] The added paragraph states that "[t]he shareholders present at a duly organized meeting can continue to do business until adjournment, notwithstanding the withdrawal of enough shareholders to leave less than a quorum."[180] This provision concerning withdrawal of shareholders was carried into the Kentucky Business Corporation Act from the previous Kentucky General Corporation Law and so does not represent any change from prior Kentucky law.[181] However, the presence of such a statutory provision would appear to call for a contrary result to that reached by the Virginia Supreme Court under the circumstances of the *Quigley* case. In other words, it would remove withdrawal from meetings as an effective defensive maneuver on the part of majority shareholders

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[176] 234 S.E.2d at 260-61.

[177] *Id.* at 261.

[178] *See, e.g.*, N.C. GEN. STAT. § 55-65(c)(1975); N.Y. BUS. CORP. LAW § 608(c) (McKinney 1963); PA. STAT. ANN. tit. 15, § 1503(A)(2) (Purdon 1967). The new California General Corporation Law, which became effective Jan. 1, 1977, recognizes the possible withdrawal of enough shareholders to break a quorum, but places some limitation on the power of the remaining shareholders to act. *See* CAL. CORP. CODE ANN. § 602(b) (West 1977). The provision reads:

> The shareholders present at a duly called or held meeting at which a quorum is present may continue to transact business until adjournment notwithstanding the withdrawal of enough shareholders to leave less than a quorum, if any action taken (other than adjournment) is approved by at least a majority of the shares required to constitute a quorum.

[179] MODEL ACT § 32. The section provides, as to quorum:

> Unless otherwise provided in the articles of incorporation, a majority of the shares entitled to vote, represented in person or by proxy, shall constitute a quorum at a meeting of shareholders, but in no event shall a quorum consist of less than one-third of the shares entitled to vote at the meeting.

[180] KRS § 271A.160(2)(Supp. 1976).

[181] KRS § 271.335(2)(b) (repealed).

in a corporation as a means of thwarting control efforts by other shareholder factions in the corporation.

Despite the contrary position taken by the Virginia Supreme Court, there seems to be considerable merit in the Kentucky statutory approach. There is no particular reason why factions of shareholders in a corporation, whether majority or minority, should be permitted to thwart the conduct of corporate affairs by the selfish expedient of breaking the quorum needed to transact corporate business. Kentucky's approach is said to represent the "modern and better view."[182]

[182] 5 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2013.1 (rev. perm. ed. 1976).